CPB Netherlands Bureau for Economic Policy Analysis

Macro Economic Outlook 2012

Chapter 1

1 The economy in 2011-2012

The global economy has clearly been slowing down since the start of this year and the current indicators are like the summer: far from sunny. As a result, Dutch GDP growth will slow to 1½% in 2011 and 1% in 2012. With these growth figures, the budget deficit will improve to 2.9% in 2012, virtually in line with the estimates at the start of the government's term of office. The improvement in government finances results partly from the government's austerity measures and tax increases. These measures can also be felt in purchasing power: 2012 will be the third year in succession of a diminution in purchasing power, averaging 1% in that year. These growth figures do take account of the recent unrest in the financial markets, but not of a new financial crisis. However, there is indeed a risk of a new financial crisis. The unrest in the financial markets indicates very high uncertainty and the chance of a negative outcome is substantial. For that reason, an uncertainty variant has been included, in which the Dutch economy shrinks in 2012.

1.1 Summary and introduction

Global economy in slowdown, markets in uproar

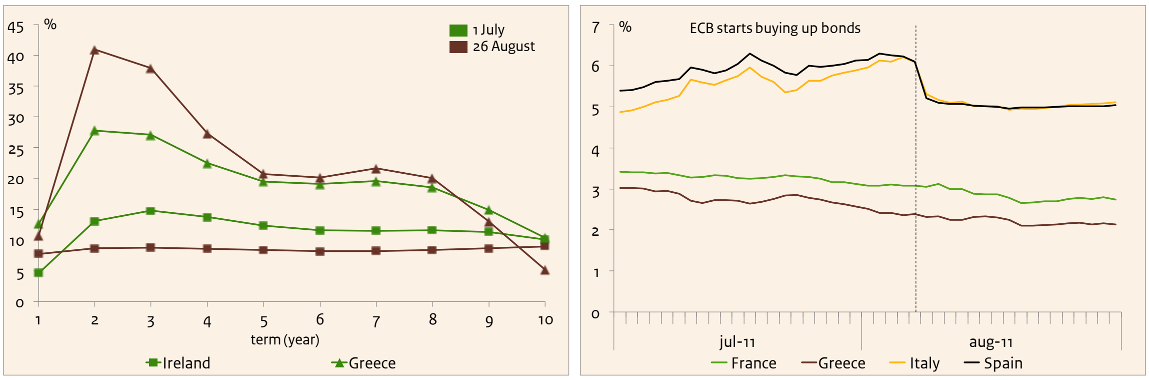
The strong Dutch GDP growth in the first quarter of 2011 was not followed up in the second quarter, but overall, the Dutch economy actually performed very reasonably in the first half of 2011. In the meantime, however, three dark clouds have appeared on the horizon. Firstly, the global economy has moved into a lower gear since the start of the year, as shown by the world trade figures and the very low and sharply downwardly adjusted growth figures in the US. Secondly, leading indicators such as those for consumer and producer confidence have been falling since the start of the year. These indicators point to continued weakening of the economy. Thirdly, the financial markets have fallen sharply since early August and are also extremely volatile.

The warning lights are lit for the global economy. The weakening of the growth rate was sharpest in the developed economies in the first half of 2011, as a result of increased uncertainty in the financial markets, budget tightening, high oil prices and the earthquake in Japan. Furthermore, import growth is weakening in emerging markets through tighter monetary policy and capacity bottlenecks. These factors will also depress growth in the second half of 2011 and in 2012. The estimates take account of meagre economic growth in the US and the euro zone. Global GDP is expected to grow 3½% in 2011 and 2012, compared with 4¾% in 2010. For the Netherlands, this will lead to a sharp diminution in export growth.

Real threat of a financial crisis in Europe, potential consequences

In July, a new chapter opened in the protracted debt crisis in the euro zone. Difficult progress in the negotiations between government leaders on the expansion of (the scale and powers of) the *European Financial Stability Facility* and new aid measures for Greece, followed by public differences of opinion on the role of the ECB, undermined the confidence of investors in a successful conclusion. Market interest rates for the long-term government debt of several euro countries rose to new record heights. In addition to the three countries that have been dependent on official external aid for some time (Greece, Ireland and Portugal); Italy and Spain also faced the threat of financial crises as a result of rising interest rates. The term structure of the interest is particularly notable in Greece: the financial markets regard the risk that the country will have to restructure or default in the near future as very high – far higher than in Ireland. Concerns about Greece have also increased sharply in recent months, while for Ireland, the markets started to demand less high interest rates. This is shown in Figure 1.1 (left), which presents the interest term structure. Interest rates for Ireland have fallen since 1 July (the line has turned down), while those for Greece have risen sharply (the line has climbed).
This applies mainly for Greek two-year rates, as the market assesses the short-term risks as very high. The long-term (10-year rates for Spain and Italy are shown in Figure 1.1 (right). This reveals that the gap between Italian and Spanish government bonds and German rose sharply at the end of July. Only after mass buying by the ECB to support these countries did interest rates fall back again (see the dotted line in Figure 1.1, right). This bought some time, but the underlying problems have not been solved.

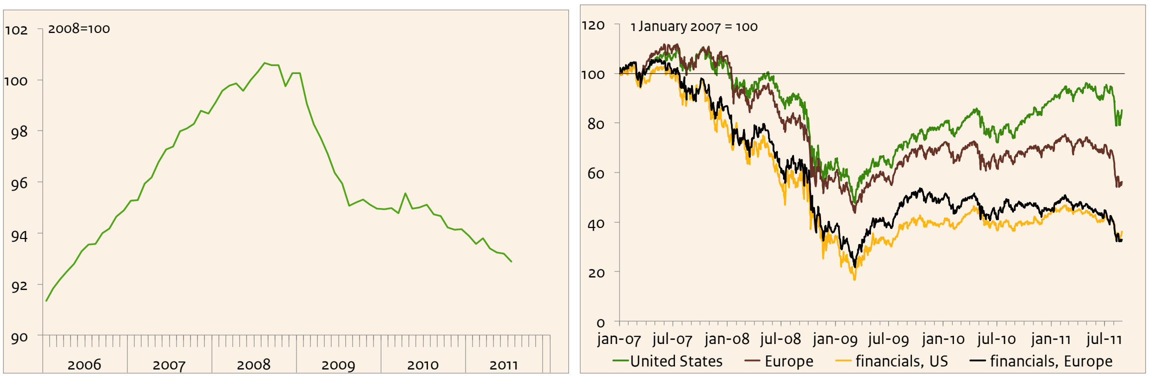
Figure 1.1 The market takes a different view of Greece than of Ireland. ECB interventions have an effect for Italy and Spain



The Netherlands has a small, open economy which follows the international business cycle. International economic or financial crises affect the Dutch economy primarily via exports, as a result of lower world trade. The precise effects of a financial crisis are difficult to quantify, but more is known about the types of channels. Firstly, the Netherlands will be affected by the direct impact of a growth slowdown (shrinkage) in the country where the crisis arises. In most cases, the direct real impact on Dutch exports will be relatively limited. By way of illustration, the consequences for the Dutch economy of severe shrinkage in one of the larger euro countries (e.g. Italy or Spain) via exports to one of those countries will probably be eliminated in the rounding off (0 to ¼% of GDP). According to the latest figures, the growth of Dutch exports remains good at present, but the outlook is less favourable.

With a financial crisis, the real financial transmission channels are more important than the real direct effects. In an article by Antony et al., to be published in the near future, four mechanisms are described.[1] The 'financial accelerator' works via the lender's collateral: because the value of the collateral (real estate, financial securities) falls, the borrower can obtain less credit, which causes further deepening of the crisis because investment consumption is deferred or abandoned. This creates a negative feedback loop, the accelerator. Figure 1.2 (left) shows that prices of residential property in the Netherlands have fallen about 7%. In practice, real estate is one of the main forms of collateral. In some countries, such as the US and Spain, the picture is more dramatic.

Figure 1.2 Residential property prices lower, as are bank share prices

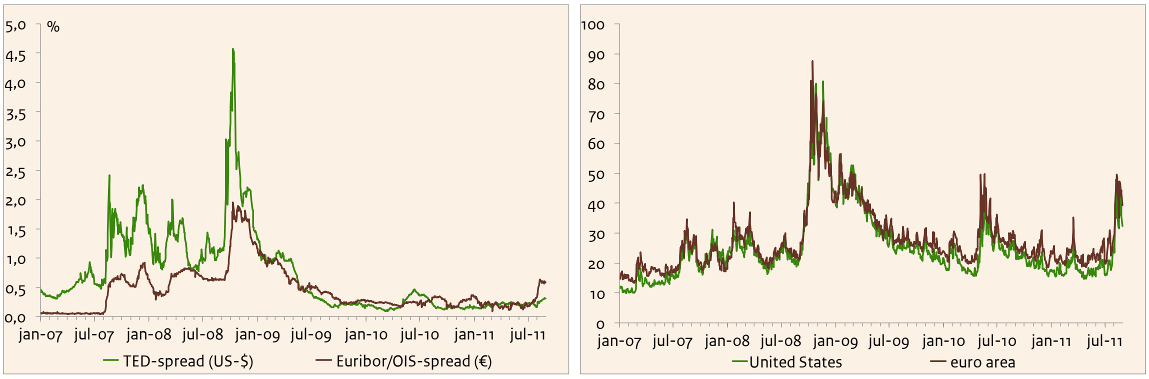


The 'bank capital channel' describes how banks make losses on their assets in a financial crisis and have to write down outstanding loans. If the losses are high, the bank's capital position can be placed in jeopardy, so that new loans cannot or may not be issued. The absence of new loans then puts a new brake on the economy. The Dutch banks have substantial loans outstanding to other euro countries: total loans to Italy and Spain amount to more than 80 billion euros. Since the start of the credit crisis, the share prices of bank worldwide have more than halved (Figure 1.2, right). However, during the drop in prices last August, bank shares did not fall more than other shares.

A third way in which unrest in the financial markets can harm the real economy is via the 'bank lending channel'. With great uncertainty in the financial markets, banks my no longer dare to lend each other money, because they are not sufficiently able to separate the sheep from the goats. That inability makes every bank a risk, bringing financial trading to a standstill. This happened after the collapse of Lehman Brothers and has also appeared to be happening again since August, as shown by the increased use of ECB credit facilities. The trust between banks in the European money market has recently diminished. This can be deduced from the increased risk premium that the banks have to pay when they borrow money from each other (see Figure 1.3). The bank lending channel therefore appears to be relevant again.

[1] J. Antony, P. Broer and C.N. Teulings, 'The Lessons of the Great Recessions for Macro Models', KVS compilation 2011, still to be published.

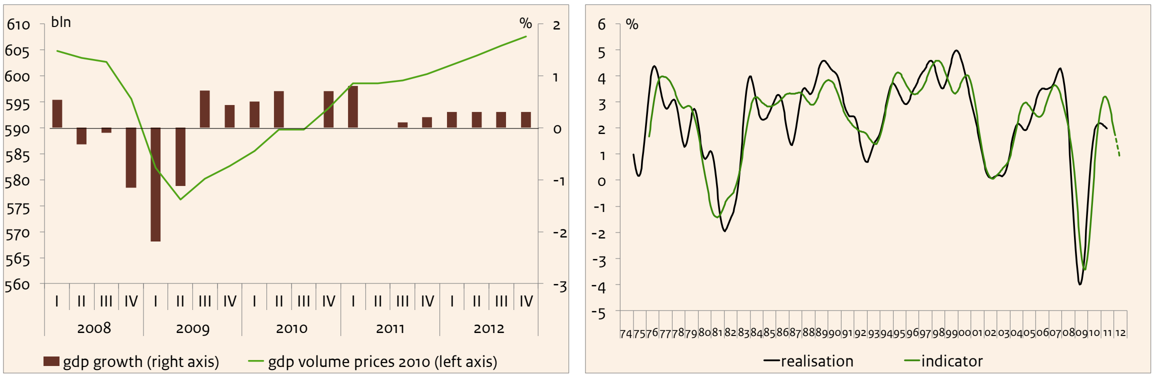
Figure 1.3 TED spread is still low (left), but volatility is high (right)



A final channel described is the 'risk channel'. With high volatility and great uncertainty, savings and capital costs rise. However the situation develops, there was certainly high volatility in August. Volatility remains very high, although not as high as after the collapse of Lehman Brothers, in historical terms (Figure 1.3, right). Although a great deal of research has been conducted (including at the CPB) into the operation of the various transmission channels of a financial blow or crisis to the real economy, it is not possible to give a uniform designation here. A sharp fall in share prices and high volatility sometimes has substantial real effects and sometimes does not. In summary, on the basis of the indicators for the transmission mechanisms discussed here from the financial to the real setting, the situation in the European financial markets clearly deteriorated in August, but far from as seriously as in the months after the fall of *Lehman Brothers*.

Because the above factors can/will play a role with all our trading partners, global trade will suffer a severe blow in the event of a new financial crisis. That is ultimately how the Netherlands will be hit hard in a new crisis. Naturally, all the other mechanisms mentioned also have an impact, but the severest blow will come through trade.

Figure 1.4 Modest growth prospects, including according to leading indicators (right)



The Netherlands: low growth, no recession

According to the latest insights, Dutch GDP will grow 1½% in 2011 and 1% in 2012. That is not a new recession, but is clearly lower than the average for the past four decades (2½%) and also less than the potential growth of 1¾% estimated in the Economic Outlook 2011-2015. Not until the second half of 2012 will Dutch GDP return to the level of before the credit crisis, which means that the economy has been at a standstill for a period of almost four years. Dutch economic growth will be tempered somewhat by the government's cut-backs and tax increases (particularly in 2012), but is primarily suffering the consequences of the global slowdown in growth, which began at the start of 2011. The estimate presented here takes account of the consequences of the severe unrest in the financial markets that broke out in early August. The base path does not take account of a new financial crisis, although there is a considerable risk of such a scenario (see the box with an uncertainty variant with a clearly more negative outcome).

In 2011 and 2012, Dutch economic growth will be achieved largely through exports. In the 2010 year of recovery, the relative importance of exports for economic growth was still considerably greater and the contribution of total domestic spending to growth was actually negative. Although a positive contribution by domestic spending is foreseen for this year and next, of ¼ to ½ percentage point per year, this contribution is limited in historical terms and the Netherlands remains more than usually dependent on other countries. This is partly due to movements in government expenditure, which place pressure on GDP growth in the years estimated. In the past four decades, a negative contribution to growth from government expenditure occurred only in 2004. However, in view of the government's extensive cut-backs, the negative impact of government expenditure is not surprising. In 2009, it was precisely government spending, with a positive contribution to growth of 1.3%, that prevented the shrinkage in GDP volume from being even more severe.[2]

Overall, Dutch consumers will not contribute to economic growth in 2011 and 2012: almost no contribution is foreseen from private consumption, following an unprecedentedly sharp shrinkage in the crisis year, 2009 (by 2.6%) and a very modest recovery in 2010. Consumers are clearly feeling the after-effects of the crisis. The increase in contract wages is not keeping pace with inflation, spending power has been diminishing since 2010, share prices were not able to maintain the rising line after their revival in 2009 and house prices have been falling for some time. Fortunately, a relatively high proportion of consumers have jobs: despite the strong recession, unemployment has risen relatively slowly and is low in international and historical terms.

Although businesses have been reporting since the start of 2009 that the economic climate is improving, due to overcapacity, this did not lead directly to a strong recovery in investment. Following a sharp fall in 2009, total corporate investments fell still further in 2010. Corporate investments are expected to show good recovery in 2011, with growth of 9¼%, but this does not yet offset the losses of recent years. As a result of the economic shrinkage in 2012, a new diminution in investment growth is anticipated in the coming year, to 3¼%. On average, the financial position of companies (profitability and solvency) appears to be reasonably in order, as a result of which companies are resistant to the estimated growth slowdown.

In early July, the government reduced the transfer tax on residential properties for a period of one year from 6% to 2%. With this measure, the government aims to stimulate the housing market, but the effect will probably be very limited. The transfer tax is a disruptive tax that restricts labour mobility, because it makes removals expensive. Although this reduction will lead to a temporary increase in the number of transactions in the housing market, the structural effects of a temporary measure on the housing market are negligible. Because both current and future demand for owner-occupied housing determines current house prices, the temporary reduction in transfer tax will have almost no impact on house prices or building production. Attempts to turn around adjustments in house prices and building production (as have occurred in the recent period) through (temporary) fiscal measures do increase pressure on the budget (and increase the total fiscal subsidy of the housing market). As noted by the IMF, among others, the tax subsidy via the mortgage interest allowance constitutes the biggest fiscal disruption of the housing market. Because of this, the average Dutch mortgage debt is high in international terms, which increases the exposure to falling prices in the housing market (see also the box in Section 4).

[2] CPB, Effects of stimulation package 2009-2010, CPB Memorandum, September 2011.

Table 1.1 Key data

	2008	2009	2010	2011	2012
	Movements in % per year				
International Economy					
Relevant world trade	1.5	-13.3	11.1	4¼	3½
Price level of goods imports	4.9	-7.3	7.3	7	-½
Competitor prices	3.9	-4.9	7.7	3	0
Oil price (Brent, level in dollars per vat)	96.9	61.5	79.5	110	106
Euro exchange rate (dollars per euro)	1.47	1.39	1.33	1.42	1.43
Dutch long interest rates (level in %)	4.3	3.7	3.0	3.3	3.3
Volume of spending and foreign trade					
Gross domestic product (GDP)	1.8	-3.5	1.7	1½	1
Consumer spending	1.3	-2.6	0.4	0	¼
Government spending	3.1	4.8	0.7	0	-1¼
Gross corporate investments (excluding housing)	7.1	-12.4	-1.4	9¼	3¼
Goods exports (excluding energy)	-0.1	-9.3	12.8	6½	3¾
- Produced domestically	-5.0	-10.5	9.4	2½	2
- Re-export	4.7	-8.2	15.8	9¾	5
Goods imports	1.9	-9.7	12.6	6¼	2¾
Prices, wages and spending power					
Price level of goods exports (excluding energy)	2.1	-5.2	4.4	2½	0
Price competition position (a)	0.0	1.8	1.8	-1¼	¾
Consumer price index (CPI)	2.5	1,2	1,3	2¼	2
Contract wages, market sector	3.5	2,7	1,0	1½	2
Wage rate, market sector	3.3	2,2	1,5	3¼	3½
Purchasing power, median for all households	-0.1	1,7	-0,4	-1	-1
Labour market (in accordance with international definitions)					
Persons employed	1.5	-0.7	-0.3	¼	¼
Labour force	1.8	0.7	-0.3	-½	¼
Employed labour force	2.3	0.1	-1.0	-¼	¼
Unemployed labour force (level in thousands of persons)	267	327	390	365	375
Unemployed labour force (level in %)	3.1	3.7	4.5	4¼	4¼
Idem, in accordance with national definition (level in %)	3.8	4.8	5.4	5	5¼
Market sector (b)					
Production	1.7	-5,1	1.3	2¼	1
Labour productivity	0.4	-2.9	2.9	3	1¼
Employment in labour years	1.3	-2.2	-1.6	-½	-¼
Price added value	0.5	2.5	2.2	0	1½
Real labour costs	2.9	-0.3	-0.6	3	2
	Levels in %				
Labour share in enterprise income	79.3	81.1	78.7	78¾	79¼
Profit share (c)	13.4	7.6	7.8	8¼	7½
Public sector					
EMU balance (in % of GDP)	0.5	-5.6	-5.1	-4.2	-2.9
EMU debt (in % of GDP)	58.5	60.8	62.9	64.6	65.6
Total tax burden (in % of GDP)	39.2	38.3	38.8	38.6	39.2

(a) Competitor price less the production price for domestically-produced goods

(b) Companies, excluding care organisations, mining and real estate sector

(c) Market sector excluding banking and insurance

Unemployment is low after the crisis, but will not fall further

On average, Dutch unemployment rose to only 4.5% of the labour force in 2010 and began to fall again in mid-2010 (until a relatively sharp month-on-month increase in July 2011). Unemployment is not expected to fall further in 2011 and 2012 and averages 4¼% of the labour force in both years. In international terms, this means that the Dutch labour market performs extremely well. At present, the Netherlands and Austria have the lowest unemployment of all OECD countries (see also paragraph 3.4). Unemployment in countries with less regulated labour markets, such as the US, Ireland and Denmark, has clearly increased more sharply. The fact that unemployment rises faster in a country with a less regulated labour market is as expected. However, the expectation is also that such a labour market will adapt faster and that as a result, unemployment will also fall more rapidly. As yet, there is little sign of this. The fact that unemployment rose more slowly in countries with regulated labour markets, such as Germany, Austria and the Netherlands, is also as expected. But the fact that the increase in unemployment halted so quickly in the Netherlands, and in Austria and Germany, and then turned into a fall, is surprising. In recent times companies have been relatively cautious about reducing their workforce, which they were able to afford due to the reasonable profits and good solvency in earlier years. Although company profits will be under pressure in the coming period, the estimates do not yet foresee a rapid and strong reduction in the workforce and sharply rising unemployment in the near future, as solvency is expected to remain relatively high.

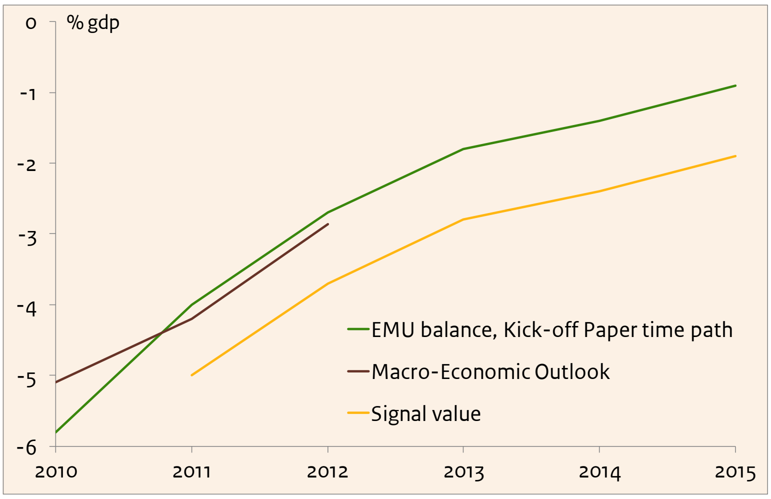
Overall, an average of 200,000 fewer people was employed in the private sector last year than in 2008. This decline in private sector jobs is expected to continue this year and next, at a slower pace of -½% and -¼% respectively. In contrast to the private sector, employment in government and in particular, in health care has continued to grow in recent years. As a result of the cut-backs, employment in government is estimated to fall by 1¾% in 2011 and 1½% in 2012. Employment in the health care sector will continue to rise steadily, by 3% in 2011 and 2¼% in 2012.

Government finances improve, partly thanks to policy....

Despite a new growth slowdown, the government deficit will diminish further next year, mainly as a result of cut-backs and tax increases. The deficit is expected to fall from 5.1% of GDP in 2010 to 2.9% of GDP in 2012. This will halve the deficit in relation to the record level of 5.6% of GDP in 2009, bringing it below the 'Maastricht' ceiling of 3% of GDP for the first time since 2008. Next year, a relatively large proportion of the austerity measures will involve social security expenditure. The increase in health care spending will continue and there will again be a budget overrun. The tax burden will increase in the projected period, from 38.6% of GDP in 2011 to 39.2% in 2012. This increase is entirely the result of policy. The increase in the tax burden contributes to the reduction of the deficit.

As yet, the European debt crisis will not have any noticeable direct impact on the government deficit in the projection period. The bilateral loan to Greece was funded through the issue of Dutch government bonds and thus means more interest payments for the Dutch Treasury. However, these extra payments will be more than offset by the Greek government's interest payments on the bilateral loan. There are indirect effects on the budget deficit, both positive and negative. The unrest in Europe has led to a flight into bonds by investors in strong euro countries such as Germany and the Netherlands. This has led to downward pressure on the government's interest payments and thus to a reduction in the budget deficit. However, the increased uncertainty also slows economic growth, which is bad for government finances.

Figure 1.5 Estimated deficit in 2012 virtually in line with the government time path



.... purchasing power will deteriorate in the coming year as a result of policy

Inflation, which was still limited in 2010, at 1.3%, is expected to rise to 2¼% in 2011 and 2% in 2012. The increase in inflation in 2011 is largely due to higher import prices. On average, the price increases for imports of energy, commodities and finished good contribute(d) more than 2½ percentage points to inflation per year in 2010 and 2011.[3] The expected slowdown in economic growth sharply decreases the foreign inflationary pressures, including through oil prices. However, the importance of the contribution to domestic factors, such as rising rents, gas prices, indirect taxation and above all, per unit labour costs, is increasing. Overall, the price increase will level off slightly in 2012 in comparison with 2011. Private sector contract wages are expected are expected to increase from 1.0% in 2010 to 1½% in 2011 and 2% in 2012. The movements in contract wages are a response, with some delay, to the increase in inflation and the diminution in unemployment.

On average, static purchasing power will fall by 1% in 2011, mainly because wages are trailing price movements. Average purchasing power will again deteriorate by 1% in 2012. Half of Dutch households will therefore see a reduction in purchasing power of more than 1%, while the remainder will be less than 1% worse off. With movements of -0.4% in 2010 and -1% in 2011, 2012 is the third successive year with negative movements in purchasing power. The aggregate median purchasing power has fallen by around 2½% since 2009. A reduction in purchasing power over several years has not happened since the early 1980s. The diminution in purchasing power in 2012 is the result of cut-backs and tax increases (and for the over-65s, the loss of indexation of supplementary pensions). Because the diminution in purchasing power is primarily the result of a large number of policy measures, the spread is broader than usual. Employees are ¾% worse off on average, compared with 1¼% for benefit claimants. Median purchasing power has fallen most sharply for single employees, due to the restriction of the transferability of the general tax allowance (‘*algemene heffingskorting*’).

[3] High commodity prices are probably also the reason why thieves stole the copper gutter pipes from the CPB building in July.

Uncertainty variant: risk of a new crisis

The *Macro Economic Outlook (MEV)* 2009 was published on 16 September 2008, one day after the failure of Lehman Brothers. The *MEV* anticipated that GDP growth would slow to a meagre 1¼% in 2009. An uncertainty variant also discussed the potential consequences of a 'persistent credit crisis'. In that case, GDP growth would slow further in 2009, to just ¾%. Ultimately, the shrinkage amounted to 3½%. This review shows that uncertainty variants are above all an illustration. It is by definition impossible to quantify all known and unknown uncertainties. Uncertainty variants are intended to give an indication of the margins that can reasonably be expected, including an idea of the scale and possible knock-on effects of on different variables.

In contrast to the usual practice, this *MEV* presents only one variant, with lower growth, in order to show that the current risks are predominantly downward. The dimensions (the severity of the blow) are also larger than usual. On average, in this variant the world trade relevant for the Netherlands will come to a standstill in 2011 and 2012, falling by 7½% in relation to the base path. Zero growth in world trade is exceptional in historical terms, but the blow in 2009 was far heavier, when world trade fell by as much as 13%.
The causes of the halt in world trade growth can be varied. Various indicators show that the US is on the brink of a new recession, or is already in one (something of which Dr. Doom Nouriel Roubini is convinced). The high political tensions and the presidential elections next year make it unlikely that an adequate policy can be developed in the short term to halt the recession and reassure the financial markets. The agreement on increasing the debt platform, and in particular, the way in which this was reached, did not convince the markets. Growing uncertainty about the (creditworthiness of the) US could easily lead to a severe slowdown in the growth of world trade.
However, the cause of a new crisis could also lie closer to home. The spreading debt crisis in Europe (of states, banks and consumers) appears to be blocking recovery at present. Political conflicts and (alleged) indecisiveness also have a strong negative impact on sentiment here. If still more euro countries have to call for financial aid, the associated unrest in the financial markets could land the European and the global economy in the scenario outlined below.
Japan is struggling with the after-effects of the natural disaster and a very strong yen. It is assumed in the base path that strong growth of public and private investments and export recovery will provide for economic recovery in the second half of this year and early next year. However, there are also concerns in Japan about political indecisiveness. Combined with a very high debt level (almost twice as high as that of Italy as a percentage of GDP), a sudden reversal of sentiment and of the economy is not inconceivable. China survived the Great Recession relatively well; so well, in fact, that there is now a degree of overheating. The base patch assumes that the Chinese authorities will be able to slow the growth to a sustainable level with restrictive policy. However, a hard landing, for example in the form of a bursting real estate bubble, cannot be ruled out. In that scenario, too, world trade would have to absorb a sever blow. None of these economic disasters is incorporated in the base path, which means that the risk of these is less than 50%. However, the risks are high at present, are predominantly downward and the dangers come from different angles.
Because the consequences for the Netherlands of all the causes mentioned primarily come via world trade, a crisis variant has been chosen in which the volume of relevant world trade is 1.3% lower than the central path this year and 7.5% lower next year, bringing growth more or less to a standstill; in that case, the limited remaining growth in world trade this year (3%) would be followed by shrinkage on virtually the same scale next year. The international crisis is accompanied by lower import prices, while in the crisis scenario, oil prices are almost 20 dollars lower than in the central path. The interest on Dutch government bonds would be 0.8 percentage points lower in 2012, at 2.5%. However, the spread would increase, making it more expensive for companies to borrow. In the crisis scenario, consumers would face sharp equity losses, assuming that share prices (AEX) will be some 15% lower next year than in the central path and house prices about 4.5% lower.

Effects of a new crisis

	2011	2012	2011	2012
Cumulative variations from	MEV estimate + variant			
	the MEV estimate, in %		movements in % per year	
Relevant world trade, volume	-1.3	-7.5	3.0	-2.8
Import prices for goods	-1.3	-6.3	5.5	-5.6
Long interest rates on Dutch government bonds (level in %)	-0.3	-0.8	3.0	2.5
Long interest rates in market sector (level in %)	0.4	1.0	-	-
Oil prices (level, dollars per vat)	-5.0	-19.8	104.3	85.7
AEX share prices	-5.4	-15.1	-	-
House prices	-0.9	-4.6	-	-
GDP, volume	-0.3	-2.6	1.3	-1.4
Private sector production, volume	-0.4	-3.7	1.8	-2.2
Domestic consumption, volume	-0.3	-1.7	-0.3	-1.2
Corporate investments, volume	-1.2	-12.1	7.9	-8.1
Investments in housing, volume	0.0	-3.3	3.4	0.7
Exports of goods (excluding energy), volume	-1.1	-6.6	5.3	-2.1
Employment, labour years	-0.1	-1.1	-0.3	-0.9
Unemployment (level, % of labour force)	0.1	1.1	4.3	5.3
Private sector contract wages	0.0	-1.0	1.5	1.0
Consumer price index (CPI)	-0.1	-1.1	2.2	0.9
Purchasing power, median for all house	0	0	-1	-1
EMU balance (level, % GDP)	-0.1	-1.3	-4.4	-4.2

Consumer confidence also falls still further, placing extra pressure on the growth in domestic consumption. Finally, it is assumed that lower pension fund yields will demand limitation of indexation to 90% in 2012 (pensions are reduced) and that there will be a negative impact on both the number of transactions for existing owner-occupied housing and for new-build housing.

In the crisis variant, GDP growth will be 0.3% lower than the central projection this year and 2.3% lower next year. In that case, the GDP volume would shrink 1.4% in 2012, while the production volume in the market sector will fall by more than 2%. Families would have to consume less for two years in succession, while companies would have to sharply scale down their investments in 2012. In the alternative crisis scenario (last two columns with figures), export volumes fall for the second time in 35 years in 2012. The first time that this happened was in 2009. Employment (in labour years) falls by almost 1% in 2012 in the crisis scenario, while unemployment climbs steeply in the course of the year (to an annual average of 5.3%). The only bright spot is that inflation will fall to just below 1% in 2012, as a result of lower international prices, including for oil, and the lower capacity utilisation. In the variant, median purchasing power remains unchanged for all households. However, pensioners will be worse off due to the reduction in pensions and employees and benefit claimants will be slightly less worse off in relation to the MEV position. In 2009, too, we saw that in the first instance, purchasing power was not affected by the crisis, because wages respond to the economic malaise with a delay. As a result of the economic crisis, the EMU balance deteriorates, particularly in 2012. In the alternative scenario, the improvement in the EMU balance foreseen in 2012 largely vanishes and the EMU balance would turn out at -4.2% of GDP, and consequently below the signal value. In order to avoid that, additional cut-backs and tax increases of 5 billion euros would be needed, but these would generate an additional downward effect on economic growth.
Finally, in the variant presented here, GDP growth moves towards that of the ‘black scenario’ that the CPB presented as a negative variant in December 2008. In that black scenario, growth for 2009 was -1¾. With hindsight, even the black scenario proved to be too optimistic. Uncertainty variants can illustrate the uncertainty, but cannot eliminate it.

1.2 Assessment

What began as a very manageable problem, in terms of scale, relating to the Greek budget deficit has developed in the space of two years into a full-blown European debt crisis, which jeopardises growth in Europe. The crisis has now become so serious that here and there, there is public speculation on the collapse of euro zone. It is suggested that Greece should leave, or be expelled from the European Monetary Union and should reintroduce its own currency. Some even see this as the solution to the problem. That is a misconception. Firstly, the collapse of the euro zone would not solve the underlying debt problem. Overall, Northern Europe is owed by Southern Europe. As the creditor, Northern Europe would primarily want its money back, or at least as much as possible. Expelling Greece from the euro zone would not bring a solution to the debt problem a single step closer. The second problem is somewhat more pressing. Imagine, for example, a Dutch chair manufacturer has sold chairs to a restaurant on the Greek island of Samos. The manufacturer has a receivable in euros. If Greece is removed from the euro zone, in which currency would the receivable then be denominated: euros or drachmas? Because of the expected devaluation of the drachma, it makes quite a difference. An undesirable dissolution of the monetary union will show that the answer to this question depends on all sorts of legal details. That will lead to years of costly legal proceedings and in the meantime, high uncertainty and liquidity problems for the businesses concerned. However, matters are still worse. The Dutch manufacturer could also sell chairs to a restaurant on the Ramblas in Barcelona. It knows what happened with Greece and wonders how to avoid a sudden conversion of its receivable from euros into pesetas if Spain is also removed from the euro zone later. Every exporter will be wrestling with the same question. Trade will suffer a very severe blow. Whether or not the introduction of the euro was a good thing at the time is no longer relevant. What matters is that the costs of abandoning the euro will be high in the short term. Although it is impossible to quantify such effects, they will certainly be greater than the normal uncertainties taken into account in the. For as Nobel Prize winner Joseph Stiglitz says: '*It is very hard to unscramble a scrambled egg*'.

In March, restructuring of the Greek debt seemed almost inevitable.[4] Possibly, the same applied for Portugal and Ireland, but Spain was believed at the time to be able to solve its problems on its own. After all, the Spanish budget deficit was lower than that of the Netherlands. Oddly enough, no mention was made of Italy at the time. The analyses of interest curves for the various countries discussed above show that in most cases, this conclusion still applies. However, for one country there is good news: in recent weeks, interest rates for Ireland have gradually calmed down. The financial markets have growing confidence in the recovery policy of the Irish government. The country has flexible markets. This offers prospects of renewed growth.
In the case of Greece, a decision was made on 21 July to defer collection, while there were strong arguments for a (partial) write-off.[5] The voluntary contribution of the private sector to the solution for the Greek problem primarily means that expiring loans will not be repaid, but that their term will be extended. Whether this is a contribution from the private sector depends primarily on which yardstick is used: the original principal or the market value of the receivables in the secondary market. If the market value is used, creditors have benefited rather than lost out. Whether this rescue package will in fact reduce Greece's debt depends on the assumptions used. Writing down the debt might have been a better solution. Allowing an irrecoverable debt to hang over the heads of the market is potentially detrimental to everyone, both the debtor (Greece) and the creditors, because it restricts Greece's growth prospects and thus reduces the changes of repayment.

The preference for deferment rather than writing off the debt has occurred in the past. With previous debt crises, too, it took a long time before restructuring was deployed. In the Latin American debt crisis, it took seven years before the Brady Plan was accepted by all the parties concerned. Once the original debts were written off, the confidence of the financial markets in the Latin American countries recovered surprisingly quickly and the continent began to grow again. The preference of various Member States for deferment presumably has a great deal to do with the precarious position of the European banks, which have many of these debts on their balance sheets. In that sense, the European debt crisis is in no way purely a South European problem. Northern Europe also has a problem, because its financial sector has built up substantial positions in Southern Europe without investigating the creditworthiness of those countries in sufficient depth.

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[4] M. Bijlsma, J. Lukkezen and C.N. Teulings, The Netherlands and the European Debt Crisis, *CPB* Policy Memorandum 2011-3. See page 9.
[5] Idem, see page 6

The causes of the debt crisis are not the same in every country affected by it. A connecting link is the availability of cheap credit as a result of the introduction of the euro and the associated liberalisation of the European capital market. However, the details vary from one country to another. In Greece and Italy, the problems are primarily the result of ineffective budgetary discipline in the public sector. In Spain, Portugal and Ireland, the debt crisis was primarily the result of excessive lending to the private sector. These loans led to expansion of domestic demand, particularly in the construction sector. That led to extra demand for labour in the sector producing for the domestic market and thus to higher wages. This, in turn, led to a loss of competitive position in the global market.[6] The loss of competitive position must be reversed if Southern Europe is to be able to pay its debts. Wages in Southern Europe must then come down. The best remedy for this is to make the labour market more flexible. Restricting dismissal law and unemployment benefits will mean that insiders can impose less high wage demands. Experiences in the Netherlands in the 1990s show how effective that mechanism is. In the first instance, it led to a reduction in Dutch per unit wage costs in comparison with Germany and consequently, to a spectacular reduction in unemployment. Ultimately, everyone benefited. Ten years later, our eastern neighbours have introduced the same policy as in the Netherlands a decade earlier, with similar results. Southern Europe, on the other hand, is known for its rigid dismissal legislation. More flexible labour markets in these countries would lead to lower wage costs, higher GDP growth and employment, inflation of around zero and a general improvement in their economic positions. Wages are already falling in some Southern European countries. Sooner or later, this will be reflected in the inflation figures.

However, a relative fall in wages in Southern Europe in relation to those in Northern Europe is the same as a relative increase in the North European wages in relation to those in Southern Europe. For businesses that have to compete in the global market, this is a less attractive proposition, because it will weaken their competitive position. At the same time, citizens will benefit as a result of an improvement in their purchasing power. This process will lead in a natural way to some adjustment in the balance of payments imbalances in Europe. The unavoidable consequence is that inflation in Northern Europe will be above 2% for a number of years. After all, if average inflation in the euro zone as a whole lies close to the 2% mark (the ECB target), Southern Europe can only have zero inflation if inflation in Northern Europe is higher than 2%. This does not require any policy response in Northern Europe. The market should regulate this itself, together with the ECB's monetary policy, which provides for average inflation close to 2% in the euro zone as a whole. This is a development as natural as it is desirable.

Such a combination of lower per unit wage costs in Southern Europe and higher pay increases in Northern Europe offers a way out of the European debt crisis. This process must obviously begin with lower wage increases and more flexible labour markets in Southern Europe. However, Southern Europe can only repay its net debt to Northern Europe if it is given a chance to sell part of its products elsewhere, largely in the North European market. Some of the revenue from those sales must then be deployed to reduce the debt positions. Adjustment of the competitive relationship is therefore an important step in the solution to the European debt crisis and is consequently in everyone's interest. That adjustment will be eased if the South European countries succeed in increasing labour productivity again. The annual productivity increase has dipped deeply there in recent years.[7] After all, higher productivity leads directly to lower per unit wage costs. An acceleration of productivity increases calls for structural reforms that lead to more competition, better market operations and better education. After 1982, however, the Netherlands needed more than ten years to restore order to its stagnating economy. This cannot be expected to progress mush faster in Southern Europe. The high South European debts cannot therefore be solved at a stroke and could continue to plague us for a long time to come.

Good policy on the issues discussed here is needed in order to solve the European debt crisis satisfactorily. In the short term, however, more urgent matters are at issue. In the coming months, crucial decisions must be taken regarding the ratification of the ESM treaty, the measures that Spain and Italy want to implement in order to improve their budget positions, etc. Given that uncertainty, it would be wise to think about what should then be done. Despite all the differences with the situation in the Great Depression of the 1930s, the similarities are disturbing. After the first shock in 1929, the US faced a second wave of problems in 1932 that led to the collapse of the banking system. The political response to the second shock was indeed inadequate. In view of the government's deteriorating financial position, a highly restrictive policy was pursued. As confidence evaporated in the financial markets, this led to the collapse of

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[6] *Central Economic Plan 2010*, pp. 26.
[7] Idem.

demand and halved industrial output in relation to the level at the start of 1929. [8] In 2009, the generous budgetary policy helped to mitigate the consequences of the recession world-wide, including in the Netherlands. A more restrictive policy in 2009 would have led to 100,000 more unemployed persons.[9] The current policy is aimed at rapid recovery of government finances. The government deserves praise for the persistence with which it pursues this policy. The starting position in a new recession would now be more difficult than in 2009, just as that in 1932 was more difficult than in 1929. However, if the debt crisis runs further out of control and the economy consequently falls into a temporary deep recession, the mistakes of the 1930s must not be repeated. The 10 commandments of Olivier Blanchard, chief economist of the IMF, were discussed earlier in the *Macro Economic Outlook*. These applied for the crisis in 2009 and apply once again for any new financial crisis.[10] With an unprecedentedly large drop in demand, additional cut-backs can worsen the problems. That is precisely when measures are needed that structurally steer government finances into calmer waters, such as measures relating to the pension system, health care, the housing market, mobility and the labour market. Obviously, a new global crisis will call for a coordinated approach. Countries with a solid reputation in the financial markets, as shown by the low interest on their bonds (e.g. the Netherlands and Germany) must take the lead here. Other European countries cannot permit themselves such a policy because financial markets already have little confidence in their financial position. As a result, they will be hit harder by the damaging consequences of any new recession. This is the inevitable consequence of bad policies in the past.

Finally, with all the gloom about Europe, it is important to continue to see matters in perspective. Despite the current problems, the rest of the world looks, with a mixture of envy and admiration, at what Europe has achieved in 65 years as a loose alliance of individual states. The European Union has grown as a result to become one of the biggest markets in the world – larger, for instance, than the US. One by one, internal trade barriers within Europe have been brought down. Welfare has improved substantially as a result. In the case of the Netherlands, this involves 4 to 6% extra GDP.[11] That, too, is part of the reality.

[8] B.S. Bernanke, Non-monetary Effects of the Financial Crisis in the Propagation of the Great Depression, *American Economic Review* 73 (3): 257–276, 1983.
[9] CPB, Effects of Stimulation Package 2009-2010, CPB Memorandum, September 2011.
[10] See the *Macro Economic Outlook 2011*, pgs. 16 et seq. – this primarily concerns the 2nd and 3rd commandments.
[11] A. Lejour. et al, 2008, *The Internal Market and the Dutch Economy, Implications for trade and economic growth*, CPB Document 168.

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